Sovereigns

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US Tax Package Is Negative for US Credit, but Positive for Economic Growth

If the tax and unemployment-benefit package agreed to on 6 December by President Obama and congressional Republican leaders becomes law, it will boost economic growth in the next two years, but adversely affect the federal government budget deficit and debt level. From a credit perspective, the negative effects on government finance are likely to outweigh the positive effects of higher economic growth. Unless there are offsetting measures, the package will be credit negative for the US and increase the likelihood of a negative outlook on the US government's Aaa rating during the next two years

One motivation for the two-year extension of the current personal income tax rates (put in place in 2001 and 2003 and referred to as the "Bush tax cuts") is to prevent a setback to economic and employment growth that would result from higher taxes beginning on 1 January, the expiration date of the earlier tax cuts. Keeping the existing tax rates would not provide an impetus to growth, but raising them would have a negative effect. However, the package also includes, among other things, an extension of unemployment benefits for the long-term unemployed through 2011 and a two-percentage-point cut in the Social Security payroll tax. The latter two measures will give a boost to economic and employment growth in the coming two years, with some forecasters significantly raising their GDP growth numbers in 2011 and 2012.

Higher economic growth should have a positive effect on government revenues and reduce payments related to unemployment. However, the magnitude of this positive effect will be considerably less than the foregone revenue and increased benefit expenditure, resulting in substantially higher budget deficits than would have otherwise been the case. The Congressional Budget Office's most recent estimate of the deficit for fiscal year 2011 was $1.1 trillion, or 7% of GDP, assuming no expiration of the tax cuts, and $665 billion (4.2%) in fiscal year 2012. These deficits would raise the ratio of government debt to GDP to 68.5% by the end of fiscal year 2012, compared with 61.6% two years earlier.

The net cost of the proposed package of tax-cut extensions, payroll-tax reductions, unemployment benefits, and some other measures may be $700-$900 billion, raising the debt ratio to 72%-73%, depending on the effects on nominal economic growth. The government's ratio of debt to revenue, instead of declining rather steeply over the two years from about 420% at the end of fiscal year 2010, would decline considerably less to somewhere just under 400%. This is a very high ratio compared with both history and other highly rated sovereigns.

Thus, while higher growth and lower unemployment are clearly good for the economy, the package is negative for US government debt metrics. In addition, there is a risk that the two-year extension may be renewed at the end of 2012, given that that period coincides with a presidential election. A permanent extension of the tax cuts alone (without other measures) could result in a considerable increase in deficits and debt levels unless other measures to reduce deficits are adopted. The exhibit below illustrates that the fiscal balance in the coming decade would be considerably higher under such a scenario, all other things being equal, and this would result in a worsening of the government's debt position. A package of options put forth by the fiscal commission at the beginning of this month provides a menu of such measures that would reverse these trends, but their adoption remains uncertain.